

## ECB preview: A general repetition no one really needs

Thursday's ECB meeting will again be one of those most of their officials would rather skip if they could. It should only serve as the prelude to the first QE showdown in June



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When the ECB gets together this week, the Eurozone's central bankers will look at an economy which is currently showing signs of a slowdown and very little evidence that the latest inflation projections are more than just wishful thinking. In fact, the first two months of the year were two months to forget. While the weakening of several confidence indicators could still be filed away as a leveling off from record-high levels, the slide in hard data is more worrisome. It would already need very strong March readings to avoid a disappointing first quarter

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Still, despite this short-term weakening, it is far too early for the ECB to sound the alarm bells. The optimistic tone of recent months should continue albeit with somewhat more emphasis on

downside risks and uncertainty.

As for inflation, there is very little evidence that the ongoing divide between wish and reality will change any time soon. While the ECB remains confident that inflation should pick up, hard data are telling a different story. March inflation only accelerated due to seasonal effects and core inflation remained unchanged at extremely low levels. Also, there seems to be very little price pressure in the production pipeline as producer price inflation has come down significantly from its early 2017 highs. If it was not for traditional cyclical and survey indicators, which still point to an acceleration in headline inflation, there would be very few arguments supporting the ECB's own projections of headline inflation at 1.7% in 2020.

## Lots of noise but very few new hard facts

In short, except a lot of noise stemming from the brewing trade conflict, military action in Syria and fading euro-phoria on the back of growing German opposition against Macron's Eurozone reform plans, the only "hard" changes since the last ECB meeting are currently benefiting the doves. But what does this mean for the future path of the ECB's monetary policy?

First of all, the ECB will have to find a consensus view on its own narrative. Remember that the ECB has always tied its QE programme to the "sustained adjustment in the path of inflation consistent with its inflation aim". This means that even though QE was started to tackle a deflationary threat, the sheer disappearance of such a threat should not be sufficient to stop QE. Instead, the ECB's wording has always made QE a "revamp-inflation" rather than a "fight-deflation" tool.

## Looking beyond next week's meeting

With all that in mind, there are (at least) three scenarios for the ECB's next plausible step.

### 1. An abrupt end to QE in September

This scenario would follow the initial logic of QE as a deflation-fighting tool. With the ongoing recovery, closing output gaps and headline inflation at least above 1%, no single European central banker can still seriously talk about deflation. Hence, an end to QE would be the logical consequence. This scenario, however, would not only contradict Mario Draghi's own words that he did not expect an abrupt end of QE, but it would also bring forward expectations about a first rate hike. This would be to an even earlier date than the mid-2019 recently advocated by Weidmann and other hawks. Therefore, this scenario is extremely unlikely, though not completely impossible.

### 2. Another open-ended extension

This scenario currently seems to be the mainstream ECB call. It reflects the view that there seems to be a broad consensus within the ECB that QE should be ended but that diverging views only exist on the timing and details of this end. Another "lower for longer", reducing the monthly QE purchases from currently €30bn to €15bn at least until the end of the year would be an almost organic next step in the ECB's gradual end to QE. It would also leave the door open to another extension beyond 2018 in case of an unexpected slowdown of the Eurozone economy or new downward revisions of the inflation forecasts. At the same time, however, it could be too much for the ECB hawks who are clearly advocating a clear end date for QE.

### 3. Much lower for much longer, but with an end date

Another possible compromise between hawks and doves could be a so-called “much lower for much longer”, ie, an extension of QE for another six months but then at a very low level of about €5bn. This extension could then be combined with an end date. This scenario would become more likely in case the soft patch of the first two months of the year was to continue and if the June staff projections for inflation up to 2020 remain unchanged or are even revised downwards.

## **We expect another extension of QE, at least until December and possibly even beyond**

Needless to say that there are more than only these three scenarios possible. In particular, combinations of scenarios 2 and 3 give multiple additional options. What counts most is obviously a definite end date to QE and how much in advance such an end date will be communicated. The end date is crucial. As soon as the ECB has communicated an end date for QE, the focus will immediately shift on sequencing. Sequencing will then be the ECB's main tool to steer market expectations and rates.

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### *The end data is crucial*

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Will it be six months between the end of QE and the first rate hike or could it be more (or even less)? Currently, the ECB seems to be happy with market expectations that sequencing means six months. Another topic in the beyond-QE era will be the reinvestments of maturing assets held by the ECB. When would the ECB stop the reinvestments? At the moment of a first rate hike or later? Given that the ECB has been mirroring and following the Fed's QE experience substantially, a continuation of the reinvestments looks likely. In the US, the Fed's reinvestment programme went on for another three years after the official end of QE.

Our base case scenario remains another extension of QE at least until December. We even consider the possibility of a “much lower for much longer” scenario, which would push the end of QE into 2019 and the first rate hike into the second half of 2019. To see this happen, the current soft patch of the economy would have to be longer-lasting than expected and the inflation outlook at the June meeting should – due to structural factors – remain benign.

All of this means that this week's meeting will be a general repetition or just the prelude to the big June meeting. Given the nitty-gritty discussions and controversies on the timing and details of tapering, it will be a general repetition the ECB would probably prefer to perform behind closed doors, as currently, silence is clearly more golden than any words.

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